

# THE IMPLEMENTATION OF GREEN ACCOUNTING AND ITS IMPLICATION ON FINANCIAL REPORTING QUALITY IN INDONESIA

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## Abstract

*The aim of this study is to analyze whether the implementation of green accounting affecting the financial reporting quality of listed Indonesian manufacturing companies. Earnings sustainability and value relevance are used to represent financial reporting quality from accounting and market aspects. The sample consists of 101 manufacturing companies that listed in Indonesia Stock Exchange determined by using purposive sampling technique and analyzed by using multiple linear regression method. The empirical results indicate that the implementation of green accounting has an effect on earnings sustainability but has no effect on value relevance of accounting information. This study contributes to provide insight how the capital market assesses the implementation of green accounting based on the financial reporting quality. It also expected to improve the company's environmental performance, since it is likely provides implication on the effectiveness of green industry policies.*

**Keywords:** Green Accounting, Financial Reporting Quality, Earnings Sustainability, Value Relevance Of Accounting Information

## Introduction

The company carries out a variety of ways to earn profits. The combination of high sales and low costs is one of the strategies used by companies to increase profits. To get the right combination, the company should always do research and development to find the best way in order to increase sales and cost efficient. But sometimes companies ignore environmental aspects to get cost efficient so that environmental pollution cannot be avoided.

Industry growth is often accompanied by rising environmental pollution, as happened in the province of West Java. According to head of the West Java Environmental Agency, Anang Sudarna, environmental pollution, especially in the Citarum watershed, increased along with industrial growth in West Java. Most factories operating on the banks of the Citarum watershed do not have adequate waste treatment plants so that they discharge liquid waste directly into Citarum (Warsudi, 2018). A similar case also occurred in Jambi, based on the statement of the Head of the Environmental Agency's Environmental Damage and Pollution Control Division in Jambi Province, Ardi, Batanghari river polluted by the waste of two oil palm companies. One company does not have a wastewater treatment plant and also does not have a liquid waste disposal permit, while another company has waste management and has a liquid waste disposal permit, but the processing of the company's waste does not meet the standards.

The way to get low costs by not treating waste adequately creates demands that cause company losses. According to the director of the Directorate General of Law Enforcement, Ratio Ridho Sani, since 2015 administrative sanctions on 61 companies and criminal law enforcement process on 65 cases has been issued. The consequences of costs due to environmental pollution losses are certainly greater than the cost of environmentally friendly waste treatment (Christian, 2018).

Environmentally friendly industries need accounting practices called green accounting. According to Zulhaimi (2015) green accounting refers to the element of environmental costs in the company's expense. The forms of green accounting practice are; (1) Use of environmentally friendly raw materials; (2) Waste management that does not damage the environment; and (3) Corporate Social Responsibility as a way to pay attention to the environment.

Another term related to green accounting is environmental accounting or sustainability accounting. According to Burnett and Hansen (2008), if a company wants to improve its environmental performance, accounting must be involved in it to carry out the function of collecting, calculating, analyzing and reporting environmental costs and other transactions related to the environment so that management can manage environmental aspects.

Accounting information is needed by users to make economic decisions. In order to be useful in making economic decisions, the accounting information presented in the financial reporting must be qualified. The quality of financial reporting is often associated with company performance which is reflected in sustainable earnings and measured by accounting attributes. Value relevance is one of the attributes of accounting quality (Francais et al., 2004) which shows the extent to which accounting information still has a role in assessing relevance as a basis for decision making for investors (Ibrahim et al., 2009). The higher the value relevance

of accounting information in decision making is certainly the higher the quality of financial reporting of a company.

This study intends to empirically examine the effect of green accounting on financial reporting quality as measured by earnings sustainability and the value relevance of accounting information. Previous research has examined the effect of green accounting on company performance (Zulhaimi, 2016; Tasneem et al., 2016; Nor et al., 2016; Magara et al., 2015; Ong & ang, 2014; Makori, 2013; Bassey et al., 2013; Alvarez, 2012). However, previous research that examined the effect of green accounting on financial reporting quality has not been done much, and only examined the effect of green accounting on the value relevance of accounting information (Sarumpaet et al., 2017; Semenova et al, 2010). Therefore this study intends to examine the effect of green accounting on financial reporting quality for the Indonesian capital market. This research is expected to answer the question of whether the implementation of green accounting will improve earnings sustainability and the value relevance of accounting information.

The remainder of this paper is organized as follows: the second section reviews the relevant literature, regarding green accounting and financial reporting quality, and hypotheses development; the third section describes the research design; the fourth section presents the results and discussion; and the final section provides the conclusions, limitations, and suggestions.

## **Literature Review**

### **Legitimacy Theory**

According to Deegan (2000), legitimacy theory refers to the way organizations ensure their operating activities are within the limits and norms that apply in society. In the perspective of legitimacy theory, a company will voluntarily report its activities if management considers that this is expected by the community. Legitimacy theory relies on the premise that there is a social contract between companies and communities in which it operates. The social contract is a way to explain the large number of people's expectations about how the organization should carry out its operations. The social expectations change over time. This requires companies to be responsive to the environment in which they operate.

In legitimacy theory, organizations must continually demonstrate that they have operated in behavior that is consistent with social values. This can be achieved through disclosure in company reports (Wilmshurst & Frost, 2000). To keep getting legitimacy, the company must communicate environmental activities by disclosing the social environment (Berthelot & Robert, 2011). Environmental disclosures are useful to restore, improve and maintain the legitimacy that has been received (Hadjoh and Sukartha, 2013).

### **Stakeholder Theory**

According to Ghazali & Chariri (2007), companies are not entities that only operate for their own interests but must provide benefits to their stakeholders. Furthermore, according to Rokhlinasari (2016), stakeholders are each group or individual who can influence or be influenced by the achievement of organizational goals. Based on its characteristics, stakeholders can be divided into primary stakeholders and secondary stakeholders. Primary stakeholders are people or groups without which the company cannot survive going concern, including: shareholders and investors, employees, consumers and suppliers, government and community. Secondary stakeholder groups are defined as those that influence, or are influenced by the company, but they are not related to transactions with companies and are not essential to their survival. Stakeholder theory assumes that the existence of a company requires stakeholder support, so that the company's activities also consider the agreement of stakeholders. The stronger the stakeholders, the company must increasingly adapt to the stakeholders. Social and environmental disclosure then seen as a dialogue between companies and stakeholders. Some reasons that encourage companies need to pay attention to the interests of stakeholders, namely: 1) Environmental issues involve the interests of various groups in society that can disrupt their quality of life. 2) In the era of globalization, the products that are traded must be environmentally friendly. 3) Investors in investing their capital tend to choose companies that have and develop environmental policies and programs. 4) NGOs and environmentalists are increasingly vocal in criticizing companies that care less about the environment.

### **Financial Reporting Quality**

Financial reporting quality is the suitability of financial information produced by the accounting system and not limited to financial statements in meeting the needs of interested parties, especially external companies in making economic decisions (Meigs et al., 2006; Britton et al., 2006; Gibson, 2011).

The quality of financial reporting is often associated with company performance which is reflected in sustainable earnings and measured by accounting attributes. Furthermore, financial reporting quality is also related to the performance of the capital market, where financial reporting quality is related to the performance of the company's shares in the capital market. The stronger relationship between earnings and market rewards shows that the higher financial reporting information is realized in the form of stock returns, so that the stronger relationship between corporate earnings and stock returns shows high financial reporting information (Fanani, 2009). The attributes of financial reporting quality based on accounting are accrual quality, persistence, predictability, and income smoothing. Then the quality attributes based on the market are

value relevance, timeliness, and conservatism (Muthmainnah & Wardani, 2013). In this study, financial reporting quality is measured by persistence as a measure based on accounting and value relevance as a measure based on market.

The persistence of company financial statements is how earnings conditions can continue (earnings sustainability). Good persistence will show that profit in the present period is a reflection of the past period which eventually recurs (Muthmainnah & Wardani, 2013). Whereas value relevance is one of the attributes of accounting quality (Francais et al., 2004) which shows the extent to which accounting information still has a role in assessing relevance as a basis for decision making for investors (Ibrahim et al., 2009). The higher the value relevance of accounting information in decision making is certainly the higher the quality of financial reporting of a company.

### **Green Accounting**

Green accounting is the process of identifying, measuring, evaluating, and disclosing the costs of corporate activities related to the environment (Aniela, 2012). Therefore green accounting is often also called environmental accounting. According to Cohen and Robbins (2011), environmental accounting collects, analyzes, assesses, and prepares reports of both environmental and financial data with a view toward reducing environmental effect and costs. This form of accounting is central to many aspects of governmental policy as well. Consequently, environmental accounting has become a key aspect of green business and responsible economic development.

The environmental accounting function is divided into internal and external functions (Fasua, 2011): 1) internal functions, as one of the steps of an organization's environmental information system, the internal function aims to manage and analyze the costs of environmental preservation compared to the benefits obtained, and consider effective and efficient environmental preservation through appropriate decision making. This is very necessary as a business management tool to be used by managers and related business units; 2) external functions, by revealing the results of measurements of environmental conservation activities, external functions allow companies to influence stakeholder decision making. Environmental accounting publications are expected to be used as a tool for organizations to fulfill their responsibilities for accountability to stakeholders and as a means for proper evaluation of environmental conservation activities.

Green accounting is a medium of communication with the public to convey if an organization seriously improves its environmental performance. The aim of improving environmental performance is to propose a continuous improvement performance for environmental control (Hansen and Mowen: 2009). Implementation of green accounting as part of the company's accounting system is important to consider to improve the company's environmental performance which may have a negative impact on the company's business success. In addition, it is expected to produce more accurate costs or prices for products from desired environmental processes and enable fulfillment of the needs of customers who expect environmentally friendly products. The aim of green accounting is an environmental management tool and as a communication tool with the community (Ikhsan: 2008).

### **Green Accounting and Financial Reporting Quality**

Information generated from financial reporting quality will help stakeholders in making appropriate and accurate decisions. Financial reporting is not limited to financial statements but also other information that can be taken into consideration in making economic decisions, including information about the company's environmental activities. Disclosure of environmental costs will increase the value of shareholders because of the company's concern for environmental preservation. Company shareholders can more easily and quickly obtain information from these disclosures so that they can facilitate decision making (Arisandi and Frisko, 2011).

The results of Zulhaimi's study (2015) showed that there was an increase in earnings and stock prices after the implementation of green accounting. While the results of the research by Nor et al. (2016) shows that environmental disclosure only has a positive and significant effect on profit margin but has no effect on Return on Assets (ROA), Return on Equity (ROE) and Earning per Share (EPS). Similarly, the results of the Adediran & Alade (2013) study show that environmental accounting only has a positive and significant effect on net profit margins and dividends per share but does not affect Return on Capital Employed (ROCE) and EPS.

Furthermore, the research results of Semenova et al. (2010), which examines the value relevance of environmental and social performance show a positive relation between environmental/social information and market reactions. Leading companies with higher environmental and social performance ratings tend to achieve higher stock prices, while lagging companies with lower scores trade at lower market values. While the results of the Sarumpaet et al. (2017) finds that superior environmental performance is associated with higher share price, whereas inferior environmental performance is value irrelevant to the market.

Based on the previous description, the research hypothesis is as follows:

H1: Green accounting affect the earnings sustainability.

H2: Green accounting affect the value relevance of accounting information.

## Research Method

### Sample and Dataset Selection

The population target of this study is manufacturing industry companies listed on the Indonesia Stock Exchange in 2017. The sampling technique is based on data availability, where companies that do not provide information related to research data are excluded from the sample. Furthermore, companies that have negative equity book values are also excluded from the sample to limit the negative influence of information on stock prices. After removing elements that do not provide research data information and have negative equity book values, a sample of 101 companies was obtained for this study.

### Data Analysis Method

Analysis method to test the hypotheses in this study using multiple linear regression. To test each hypotheses, a different equation is used, namely:

### Earnings Sustainability

To measure persistence, it will use an equation that calculates the regression coefficient of current period earnings per share against earnings per share last period (Fanani et al. 2007). The equation model is then modified to see its interaction with green accounting. The quality indicator of this model is if the regression coefficients that appear on green accounting are high, it shows high quality and vice versa.

Green accounting in this study is measured by the proxy of green industry awards. If the company gets a green industry award, then is given a score of 1. On the contrary, if the company does not get a green industry award, it will be given a score of 0. Green industry awards in Indonesia are given by the government as a form of appreciation to industries that run green industry practices. Although there are still few industry companies that voluntarily follow the assessment of green industries, this can be a benchmark for the application of green industry involving green accounting in its activities. This equation model uses control variables as controllers in testing the effect of green accounting on earnings sustainability. The control variables used are firm size, as a proxy for political attention variables, leverage as a reflection of the debt-equity hypothesis, and operating cash flow as a measure of company performance (Tendeeloo & Vanstraelen, 2007).

Company size (size), shows the size of the company seen from the amount of equity value, sales value, or total asset value. In this study, company size is proxied by using natural assets (Ln) total assets. The use of natural logarithms (Ln) in this study is intended to reduce excessive data fluctuations. If the value of total assets is immediately used, the variable value will be very large, billion or even trillion. By using natural logs, the billion or even trillion values are simplified without changing the proportion of the actual origin value.

Leverage (lev), aims to measure the company's funding needs through loans. Leverage also measures the composition of debt and capital owned by the company. The proxy of leverage used to measure leverage in this study is the gearing ratio. The gearing ratio, or often also called the debt to equity ratio, is the ratio between total liabilities and total capital.

Operating Cash Flow is one component of forming earnings other than accruals. Operating cash flow illustrates incoming and outgoing cash from operating activities of the company.

The regression equation to test the first hypotheses is as follows:

$$EPS_{jt} = a_0 + a_1 EPS_{jt-1} + a_2 GRAC_{jt} + a_3 SIZE_{jt} + a_4 LEV_{jt} + a_5 OCF_{jt} + e_{jt} \quad (1)$$

Description:

- EPS<sub>jt</sub> : Earning per Share of company j in year t, which is calculated by dividing profit before the extraordinary account post of company j in year t by the number of weighted average shares of company j outstanding in year t.
- EPS<sub>jt-1</sub> : Earning per Share of company j in year t-1, which is calculated by dividing profit before the extraordinary account post of company j in year t-1 by the number of weighted average shares of company j outstanding in year t-1.
- GRAC<sub>jt</sub> : Dummy variable where GRAC<sub>jt</sub> = 1 for companies that get green industry awards, and GRAC<sub>jt</sub> = 0 for companies that do not get green industry awards.
- SIZE<sub>jt</sub> : Size of company j in year t.
- LEV<sub>jt</sub> : The ratio of total liabilities to total company capital j in year t.
- OCF<sub>jt</sub> : Operating cash flow divided by total assets of company j in year t.

### Value Relevance

Qualified financial statements will increase the value relevance of a company. The value relevance in this study will be measured by stock prices. Tests are conducted both for companies that get green industry awards and companies that do not get green industry awards. The value of the coefficient of determination (R<sup>2</sup>) becomes a measure of the value relevance of accounting information reflected in the stock price. The increase in the coefficient of determination (R<sup>2</sup>) from the regression equation between companies that do not

get the green industry award and companies that get the green industry award is an indicator of increasing value relevance.

The regression equation to test the second hypothesis is as follows:

$$P_{it} = a_0 + a_1 BVPS_{jt} + a_2 NIPS_{jt} + e_{jt} \quad (2)$$

Description:

$P_{j,t}$  : share price six months after the fiscal year ended,

$BVPS_{j,t}$  : book value of equity divided by number of shares,

$NIPS_{i,t}$  : net income divided by number of shares.

## Result and Discussion

### Earnings Sustainability

Descriptive statistics from 101 observations can be seen in table 1. The average EPS of all companies is 136.65, with a minimum value of 0 and a maximum value of 1.310. The average EPS of the previous year was 171.22, with a minimum value of -32 and a maximum value of 3.137. Both the EPS average and the previous year's EPS indicate that the sample has a wide range. The average GRAC of 0.22 indicates that there are still few industry companies that apply green accounting. Furthermore, the average SIZE was 28.73, the average LEV was 1.96, and the average OCF was 6.86.

Hypotheses Testing, in this study to test the first hypothesis, namely the effect of Green Accounting on Earning Sustainability, multiple linear regression analysis was used with SPSS version 22 software.

**Table 1. Descriptive Statistics**

Descriptive Statistics					
	N	Minimum	Maximum	Mean	Std. Deviation
EPS	101	.00	1310.00	136.6535	251.38287
EPSb	101	-32.00	3137.00	171.2178	387.96656
GRAC	101	.00	1.00	.2178	.41482
SIZE	101	26.00	33.00	28.7327	1.64858
LEV	101	.00	94.00	1.9604	9.36047
OCF	101	-21.00	53.00	6.8614	9.69952
Valid N (listwise)	101				

Source: Output SPSS 22 based on research data

Based on the test results obtained regression coefficient values as shown in table 2.

**Table 2. Multiple Regression of Earnings Sustainability Coefficients<sup>a</sup>**

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-1147.282	385.436		-2.977	.004
	EPSb	.371	.053	.489	5.975	.000
	GRAC	59.407	55.898	.098	1.063	.291
	SIZE	41.660	13.571	.273	3.070	.003
	LEV	-.152	2.128	-.006	-.072	.943
	OCF	2.927	2.214	.113	1.322	.189

a. Dependent Variable: EPS

Source: Output SPSS 22 based on research data

From the results of data processing presented in table 2, a regression equation model can be formed as follows:

$$EPS = -1,147 + 0.317 EPSb + 59.407 GRAC + 41.660 SIZE - 0.152 LEV + 2.927 OCF$$

The regression equation obtained explains that the previous year's EPS, Green Accounting, SIZE and operating cash flows have a positive influence on EPS, which means that the higher the previous year's EPS, Green Accounting, SIZE and operating cash flow, will be followed by the higher EPS. While LEV has a negative influence on EPS, which means that the increase in LEV will be accompanied by a decrease in EPS or vice versa.

Based on table 2, it is known that GRAC has a high regression coefficient of 59.407, which indicates that Green Accounting improves the quality of earnings sustainability. In other words, the implementation of



Green Accounting has an effect on the Financial Reporting Quality. Therefore hypothesis 1 in this study is acceptable.

#### Value Relevance

In this study testing the second hypothesis using multiple linear regression analysis. Regression coefficients are calculated for companies that implement Green Accounting and companies that do not implement Green Accounting separately using SPSS version 22 software.

Based on the test results obtained regression coefficient values for companies that implement Green Accounting as shown in table 3.

**Table 3. Multiple Regression of Value Relevance for Companies that implement Green Accounting Coefficients<sup>a</sup>**

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	938.468	1287.354		.729	.475
	BVPSGRAC	1.106	.441	.457	2.509	.021
	NIPSGRAC	.159	.082	.355	1.951	.066

a. Dependent Variable: PGRAC

Source: Output SPSS 22 based on research data

From the results of data processing presented in table 3, a regression equation model can be formed as follows:

$$\text{PGRAC} = 938.47 + 1.106 \text{ BVPSGRAC} + 0.159 \text{ NIPSGRAC}$$

The regression equation obtained explains that the book value of equity per share and net income per share has a significant positive effect on stock prices, which means that the higher the book value of equity per share and the net income per share will be followed by the higher the stock price.

Furthermore, the regression coefficients for companies that do not implement Green Accounting are shown in table 4.

**Table 4. Multiple Regression of Value Relevance for Companies that do not implement Green Accounting Coefficients<sup>a</sup>**

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	493.651	507.959		.972	.334
	BVPSNGRAC	.158	.203	.045	.776	.440
	NIPSNGRAC	.477	.030	.903	15.712	.000

a. Dependent Variable: PNGRAC

Source: Output SPSS 22 based on research data

From the results of data processing presented in table 4 the regression equation model can be formed as follows:

$$\text{PNGRAC} = 493.651 + 0.158 \text{ BVPSNGRAC} + 0.477 \text{ NIPSNGRAC}$$

The regression equation obtained explains that the book value of equity per share and net income per share has a significant positive effect on stock prices, which means that the higher the book value of equity per share and the net income per share will be followed by the higher the stock price.

To answer the second hypothesis testing the coefficient of determination (R<sup>2</sup>) of each regression equation of the company that implement Green Accounting and companies that do not implement Green Accounting which can be seen from tables 5 and 6.

Based on table 5, it can be seen that the variation in the company's stock price that implement Green Accounting can be explained by variations in the book value of equity per share and net income per share is 39.5%. Furthermore, from the results of the F test obtained F value of 7.854 with a probability of 0.003 (smaller 0.05). Means the regression model can be used to predict stock prices and it can be said that the book value of equity per share and net income per share simultaneously affect the stock price of companies that implement Green Accounting.

Based on table 6, it can be seen that variations in companies that do not implement Green Accounting can be explained by variations in the book value of equity per share and net income per share of 87.2%. Furthermore, from the results of the F test obtained F value of 271,102 with a probability of 0,000 (smaller

0.05). Means the regression model can be used to predict stock prices and it can be said that the book value of equity per share and net income per share jointly affects the stock price of companies that do not implement Green Accounting.

In accordance with the coefficient of determination obtained, it can be seen that companies that implement green accounting have smaller coefficients compared to companies that do not implement green accounting. Thus it can be said that the application of Green Accounting has no effect on increasing the value relevance of accounting information, therefore hypothesis 2 is rejected.

**Table 5. Coefficient of Determination of Value Relevance for Companies That Implement Green Accounting**

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.673 <sup>a</sup>	.453	.395	4326.99755

a. Predictor: (constant), NIPSGRAC, BVPSGRAC

ANOVA <sup>a</sup>						
Model		Sum of Square	df	Mean Square	F	Sig.
1	Regression	294117975.100	2	147058987.550	7.854	.003 <sup>b</sup>
	Residual	355735247.673	19	18722907.772		
	Total	649853222.773	21			

a. Dependent Variable : PGRAC

b. Predictor: (Constant), NIPSGRAC, BVPSGRAC

Source: Output SPSS 22 based on research data

**Table 6. Coefficient of Determination of value relevance for companies that do not implement green accounting**

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.936 <sup>a</sup>	.876	.872	4025.22465

a. Predictor: (constant), NIPSNRAC, BVPSNRAC

b. Dependent Variable : PNRAC

ANOVA <sup>a</sup>						
Model		Sum of Square	df	Mean Square	F	Sig.
1	Regression	8785028361.740	2	4392514180.870	271.102	.000 <sup>b</sup>
	Residual	1247587378.247	77	16202433.484		
	Total	10032615739.988	79			

a. Dependent Variable : PNRAC

b. Predictor: (Constant), NIPSNRAC, BVPSNRAC

Source: Output SPSS 22 based on research data

The results of this study are not in line with the research of Semenova et al. (2010) and Sarumpaet (2017). This could be due to the fact that there are still a few industrial companies, which are the research samples, that apply Green Accounting. Only about 21% of the samples have applied Green Accounting. The results of this study also indicate that the stock price for the sample under study is not determined by the information submitted to the public.

## Conclusion

This study aims to empirically examine the effect of Green Accounting on Financial Reporting Quality. Green accounting uses companies that get green industry awards from the Indonesian government as proxies. While financial reporting quality is measured by earnings sustainability and value relevance. The results showed that green accounting had an effect on increasing earnings sustainability but did not affect value relevance.

Several limitations of this study are; 1) research is only conducted for one observation period, therefore it cannot describe its effect for long period, 2) measurement of green accounting only uses companies that get green industry awards as proxies so it cannot accurately describe the implementation of green accounting, 3) measurement of financial reporting quality is only limited to persistence and value relevance, 4) measurement of value relevance only uses stock prices, so it cannot describe the return of shares that are not caught at the stock price.

Further research is expected to add to the observation period to get a wider picture of this research. In addition, further research is expected to use a more appropriate measure to describe green accounting, such as the element of environmental costs, and furthermore, future research is also expected to use a more complete measurement of financial reporting quality, such as: relevance, faithful representation, comparability, verifiability, timelines, and understandability

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